

Market Watch

Economic commentary

Last month the Reserve Bank of Australia (RBA) increased interest rates and reduced its forecasts for Australia's economic growth. In March it released its six monthly review of Australia's financial stability. Normally this would pass unnoticed but in 2008 financial stability has become 'top of mind'.

The RBA's conclusion was that Australia's financial system was relatively well positioned to cope with the difficulties currently faced by financial markets. Banks had high quality assets with very low levels of non-performing loans and had not significantly lowered their lending standards. The report's overview can be found on the RBA website www.rba.gov.au.

In other news, Australia's unemployment rate fell to 4.0%, building approvals rose 5.1% on a year earlier and retail spending was up 7.1% on a year ago. Australia's economy grew 4.3% in the year to December while oil prices rose to \$US110 per barrel before ending the month at \$US101 per barrel.

The Australian dollar (AUD) fell 2.4% against the US dollar (USD) during the month as US interest rates fell. It started the month at US 93.62 cents and ended it at US 91.36 cents. A year ago the AUD stood at US 81.05 cents. The AUD bought 0.4598 UK pounds at the end of March and 1.161 NZ dollars.

Australian shares

The Australian sharemarket suffered its fifth consecutive monthly fall during March with the S&P/ASX 300 Accumulation index down a further 3.4%. It is 15 years since the market experienced a similar run of monthly results. Over 12 months, the sharemarket has provided a return of negative 7.2% but is down 14.6% over the first three months of 2008.

Keeping the sharemarket under pressure was another increase in official interest rates and ongoing turmoil in credit markets.

Credit markets are where larger companies can raise finance or debt if they choose not to seek loans directly from a bank. Changes in attitudes towards risk, in the wake of the US sub-prime issue, have seen lenders unwilling to lend and any loans made are at far higher interest rates than were seen six months earlier.

Higher interest rates across the economy are expected to slow economic activity and crimp the profits of corporate Australia. Issues that threaten profits have a negative impact on equity markets, hence the decline in the market. The S&P/ASX All Ordinaries index hit a new low for 2008 of 5164 points in March.

Not all the news was bad. Offshore sentiment picked up in mid-March as the US Federal Reserve cut its official interest rate and as it took action to support the US financial system. The 'Fed' stood behind investment bank JPMorgan Chase as it purchased its struggling rival Bear Stearns.

The 'Fed's' actions lifted sentiment towards the Australian financial (ex-property) sector which rose 0.7% in the month. Among the banks, St George rose 8.0%, National Australia Bank was up 4.5%, ANZ rose 2.5%, Westpac was up 1.8% but Commonwealth Bank fell 0.8%.

Also assisting the market were a number of proposed mergers. Incitec Pivot, a producer of fertilizer made a \$3.3 billion bid for explosives manufacturer Dyno Nobel. Miner, Oxiana made a \$6 billion bid for fellow miner Zinifex while Spotless Group made a \$0.55 billion offer for Programmed Maintenance.

Despite snippets of good news, most sectors of the market fell during March. Among the worst hit sectors were materials (-8.7%), consumer discretionary (-8.0%) and telecommunications (-7.7%).

Weakness in some commodity prices and a rotation by investors away from resource companies and towards banks did not help the materials sector. BHP Billiton fell 9.5%, Rio Tinto was down 10.6% and Oxiana fell 18.9%. Within telcos, Telstra was down 6.8% while among consumer discretionary companies, ABC Learning fell 30.8% and Harvey Norman was down 14.1%.

Further market volatility over the next few months is likely. The US Fed is doing what it can to cushion the blow of the sub-prime problem but acting in the opposite direction for our market is the impact of higher Australian interest rates.

Credit markets are under stress in Australia and companies in need of debt face significantly higher costs, assuming someone will lend them money. Until trust is restored in this market and participants feel sure their loans are 'safe', the equity market will struggle to make headway.

Global shares

Major sharemarkets were mostly weak during March. The MSCI World index, a broad measure of global shares, fell 1.3% in USD terms but was up 1.2% when measured in AUD. Over 12 months global shares were down 5.1% in USD terms and fell 15.9% in AUD terms.

Unsettling markets around the world were the ongoing turmoil in credit markets, high and volatile oil prices and the US economic slowdown.

US markets held up relatively well following the actions of the Federal Reserve. The Fed cuts its official cash rate from 3.0% to 2.25%. It helped JP Morgan move towards the purchase of rival bank Bear Stearns and it provided funds to a set of financial institutions that are normally outside of its sphere of care.

The Dow was flat in March, the S&P500 was down 0.6%, and the NASDAQ rose 0.3%. Over 12 months the Dow is down just 0.7%, S&P index is down 6.9% and the NASDAQ has fallen 5.9%.

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Holding back the US market is the continued fall in US house prices. The S&P / Case Shiller index of house prices, which covers 20 major cities, fell 10.7% in the 12 months to January. Falling house prices are a root cause of losses experienced by banks as home owners walk away from their loans and homes. Lower interest rates may help the situation as might the dearth of new home building but weakness is expected to continue for much of 2008.

Asian markets were particularly weak. Japan's Nikkei index fell 7.9% in the month to be down 27.6% over 12 months. Japan is experiencing anemic economic growth as its stronger currency has held back export growth. China's Shanghai B market, the market in which foreigners may invest, fell 17.6% in March but is still up 44.0% over 12 months.

In Europe, interest rates remain on hold as the European Central Bank continues to express concerns about inflation. A slowing economy may see the focus change and interest rates fall later in the year. The German sharemarket fell 3.2%, France was down 1.7% and the Italian market fell 5.6%. The Italian market is down 22.9% over 12 months.

The UK's FTSE 100 index fell 3.1% in March to be down 9.6% over 12 months. The UK cut its official interest rates in February as the economy showed signs of slowing. The slowing economy is hurting the outlook for earnings and, combined with problems in credit markets, is putting downward pressure on share prices.

The MSCI Emerging Markets price index fell 5.4% in USD during March but is up 5.5% in AUD terms over 12 months.

Problems in global credit markets and the fallout from sub-prime issues will not disappear overnight. The US 'Fed' has taken steps to ease strains in the US financial system and, over time lower interest rates will help turn the US economy around. Further short-term volatility seems likely as companies and markets adjust to the ever changing environment around them.

Fixed interest

In March the Reserve Bank of Australia (RBA) lifted its official cash rate from 7.00% to 7.25%, once again citing inflation as

a major concern. The RBA has noted that its rate increases have been 'substantial' and it will be hoping that these have been enough to temper demand and ease pressure on inflation.

Ninety day bank bills began the month at 7.99%, moved up to 8.11% and ended the month at 7.86%. The UBSA Bank Bill index returned 0.67% in March and 6.99% over 12 months.

Credit markets remain unsettled. Companies with credit ratings in the range BBB- to BBB+ saw average yields on their corporate bonds rise from 9.15% at the end of January 2008 to 10.31% by the end of March 2008.

Australian government 10 year bond yields were lower at the end of March than they were at the end of December however there has been some volatility. They ended 2007 at 6.33%, have been as low as 5.87% and as high as 6.48% before ending March at 6.05%. The UBSA Composite Bond index returned 1.60% in March for a return of 4.29% over the past 12 months.

Listed property

The listed property sector posted a small rise in March following a very difficult period since November 2007. The S&P/ASX 200 Listed Property Accumulation index rose 0.4% to be down 22.8% over 12 months.

The sector had been sold heavily but buying returned to a number of trusts. Westfield Group rose 1.7%, Commonwealth Property Office Fund rose 2.3% while CFS Retail Property Trust was up 2.4%.

At the end of March, the estimated distribution yield on the listed property sector was 7.5%, compared with the 6.2% yield on a 10 year government bond. This difference in yield, combined with ongoing growth in the economy, should provide some support for the sector over the remainder of 2008.

Global property markets stabilised a little in March. The S&P/Citigroup World Property index rose 2.3% in AUD terms although it was down 0.2% in USD. Debt issues continue to unsettle investors.